JACKO LAW GROUP, PC

Legal Risk Management Tip
March 2018

Where Do Cryptocurrencies Fit in the Regulatory Landscape?

Cryptocurrencies have generated a lot of recent press as a result of some currencies experiencing huge gains in value and/or experiencing large volatility. This has prompted industry professionals and investors alike to consider adding cryptocurrencies as part of an overall investment portfolio. Exactly how this can be accomplished will vary based upon the type of cryptocurrency and manner in which it is obtained.

Unfortunately, this swelling interest in cryptocurrencies has also resulted in scams from unscrupulous persons seeking to take advantage of this new and developing area. As a result, securities regulators are searching for how to classify cryptocurrencies for regulatory oversight purposes. This article is designed to provide an overview of cryptocurrencies, and how they are currently being assessed by securities regulators.

A. What is Cryptocurrency

Fundamentally, "what exactly is cryptocurrency"? Notably, cryptocurrency is *not* a tangible medium of currency. You can't go to your bank and ask for a bar made of solid "Bitcoin." You can't conduct a transaction by handing over a briefcase full of "Ether."[1] Rather, cryptocurrencies are a form of digital currency that can be exchanged online for goods and services. Many companies have issued their own currencies (typically referred to as token) that can be traded specifically for the good or service for which that company provides.[2]

Cryptocurrency operates on "blockchain" technology - a decentralized digital and public transaction database, functioning as a distributed ledger.[3] This technology is the process of converting legible information into code, to track purchases and transfers.[4] Thus, it is important to remember that when discussing cryptocurrencies, there exists two separate but intertwining components.

The first component is the "token" itself - which is code that represents value. The second component is the "platform" in which the token exists - an online network that maintains a ledger of the balances.[5] For example, when people refer to Bitcoin, there is Bitcoin the platform, and Bitcoin the token. Both are usually lumped together, but understanding the difference helps to understand why different cryptocurrencies exist. Each platform claims to do something a bit different, and the "currency" associated with the platform is how you transact in that space. New cryptocurrencies are created as part of Initial Coin Offerings ("ICOs"). An ICO involves the raising of funds – similar to an Initial Public Offering ("IPO") of stock.

What gives cryptocurrencies their value is the belief that the "currency" you own has value. This is true in much the same way as people believe fiat currencies (*i.e.*, USD, EUR, etc.) have value, or that their bank account statements that show them as having money at the bank represents real value, even though the vast majority of such money isn't actually in the bank (as Mr. George Bailey so aptly explained in "It's a Wonderful Life"). Unlike with the banking industry though, where there exists a central over-arching authority (whether that be at the state or federal level), cryptocurrencies occupy a decentralized space with no authority figure.

[1] "Ether" is the cryptocurrency of the Etherum network.
[2] See https://www.nerdwallet.com/blog/investing/cryptocurrency-7-things-to-know/
[3] See https://en.wikipedia.org/wiki/Cryptocurrency
[4] See https://www.telegraph.co.uk/technology/0/cryptocurrency/
[5] See https://www.coindesk.com/information/what-is-bitcoin/

B. Who Regulates Cryptocurrency

As mentioned above, cryptocurrency is the digital currency associated with blockchain technology –a decentralized internet-based technology. Therefore, it has no inherent regulation or governing body, and the technology is solely controlled by its algorithmic coding. As a result, securities regulators worry about the propensity for scammers to take advantage of investors in this space without regulatory oversight. But where does cryptocurrency fit into the traditional regulatory scheme? The problem is that this new "round peg" doesn't fit neatly into any of the "square holes" the regulatory industry has built over the better part of the last century. Is it truly a currency, a security or something else? That's the question that is still being addressed by countries around the world as well as in the Unities States by the Securities and Exchange Commission ("SEC"), Commodities Futures Trading Commission ("CFTC") and others.

1. SEC Position

As part of recent testimony before the Committee on Banking, Housing, and Urban Affairs of the United States Senate, Jay Clayton, the chairman of the SEC, addressed this very topic. In his testimony, Mr. Clayton made clear the SEC's intention is not to stifle growth or innovation, but cited concern due to "risks caused by or related to poor, incorrect or non-existent disclosure, volatility, manipulation, fraud and theft" that could be experienced by investors in cryptocurrency.

Mr. Clayton noted that that many of the U.S.-based cryptocurrency trading platforms have elected to be regulated as "money-transmission services." The SEC regulates securities transactions and certain individuals and firms who participate in securities markets, but does not have direct oversight of transactions in currencies or commodities, including currency trading platforms. However, Mr. Clayton went on to state that "while there are cryptocurrencies that…do not appear to be securities, simply calling something a "currency" or a currency-based product does not mean that it is not a security." Ultimately, Mr. Clayton stated that "determining what falls within the ambit of a securities offer and sale is a facts-and-circumstances analysis, utilizing a principles-based framework."[6] Therefore, before characterizing a cryptocurrency as truly being "currency," it should be analyzed as to whether it has properties that would cause it to be deemed a security; and if deemed a security, its promoters cannot make offers or sales unless they comply with the registration and other requirements under federal securities laws.

The SEC exemplified this position in a Report of Investigation (Rel. No. 81207, July 25, 2017)[7] concerning Decentralized Autonomous Organization ("DAO") tokens. The DAO performed an ICO in 2016 and invited people to buy tokens (raising nearly $150 million) that would be used to pursue an automated investment strategy and entitle the token owners to receive "rewards."[8] After review, the SEC stated in their report that DAO tokens were in fact securities and should have been registered with the SEC. While the SEC elected not to go after individuals involved with the ICO, the report served as a warning to caution the industry and market participants that cryptocurrencies may be deemed a security under these facts and circumstances.

Currently, the SEC is intensifying its focus on ICOs and virtual currency trading platforms in an attempt to thwart possible fraudulent activities. According to a recent report[9], Stephanie Avakian, the SEC Enforcement Division's Co-Director, stated that the SEC has "dozens" of investigations open in the cryptocurrency space. Ms. Avakian went on to state that while the SEC is currently "very active," she would "expect to see more and more" investigations by the SEC into such matters.

2. CFTC Position

In addition to efforts by the SEC, the CFTC has been dedicating itself to deciding how it should classify cryptocurrency. One thing that has been made clear, in most instances, the CFTC will treat cryptocurrencies

[6] This is referring to the "Howey Test" promulgated by the United States Supreme in the case of SEC v. Howey Co..
[7] See https://www.sec.gov/litigation/investreport/34-81207.pdf
[8] See http://fortune.com/2017/07/26/sec-icos/
[9] See https://www.bna.com/sec-working-dozens-n57982089945/

as a commodity. In fact, the CFTC has distributed materials unequivocally stating that "virtual currencies…have been determined to be commodities under the Commodity Exchange Act."[10] As such, the CFTC has jurisdiction to oversee certain aspects of cryptocurrency trading. For instance, the CFTC's jurisdiction is implicated when "a virtual currency is used in a derivatives contract, or if there is fraud or manipulation involving a virtual currency traded in interstate commerce."[11] The CFTC has also provided certain examples[12] of prohibited activities involving cryptocurrencies which include, but are not limited to:

- Price manipulation of a virtual currency traded in interstate commerce.
- Pre-arranged or wash trading in an exchange-traded virtual currency swap or futures contract.
- A virtual currency futures or option contract or swap traded on a domestic platform or facility that has not registered with the CFTC.
- Certain schemes involving virtual currency marketed to retail customers, such as off-exchange financed commodity transactions with persons who fail to register with the CFTC.

The CFTC has brought a number of virtual currency enforcement actions in recent months.[13] Additionally, the CFTC permitted two U.S. exchanges last year to list Bitcoin futures contracts - the Chicago Mercantile Exchange Inc. ("CME") and the CBOE Futures Exchange ("CFE") self-certified new contracts for Bitcoin futures products.[14] Theoretically, the introduction of Bitcoin futures contracts increases the CFTC's authority over the cryptocurrency by giving it jurisdiction over the commodity underlying those contracts. The CFTC also announced that it will be working closely with the National Futures Association ("NFA") in monitoring the futures contracts.[15]

C. Conclusion

Cryptocurrency and the technology they are predicated upon appear to be gaining support. There's every reason to believe at this time that they will continue to grow and find a market with investors domestically and abroad. As such, there is little doubt that virtual currencies will generate significant attention in the future by regulators. Whether a cryptocurrency should be registered with one or more regulatory bodies will be a facts and circumstances analysis. Prior to investing in cryptocurrencies, or recommending others do so, thorough due diligence should be performed to assess the nature of the cryptocurrency itself and the manner in which it is being traded. Failure to do so can result in significant investment losses and/or regulatory scrutiny, if not regulatory action.

If you have additional questions regarding cryptocurrencies in the regulatory landscape, please contact us at (619) 298-2880 or at info@jackolg.com.

Author: Robert R. Boeche II, Esq., Sr. Associate, Jacko Law Group, PC (JLG), Editor: Michelle L. Jacko, Esq., Managing Partner, Jacko Law Group, PC (JLG). JLG works extensively with investment advisers, broker-dealers, investment companies, private equity and hedge funds, banks and corporate clients on securities and corporate counsel matters.

---

[10] See http://www.cftc.gov/idc/groups/public/@customerprotection/documents/file/oceo_bitcoinbasics0218.pdf
[11] Id.
[12] See https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/labcftc_primercurrencies100417.pdf
[13] For more information, please see: Complaint, Commodity Futures Trading Commission v. Dean et al., No. 2:18-cv-345 (E.D.N.Y. Jan. 18, 2018); Complaint, Commodity Futures Trading Commission v. McDonnell et al, No. 1:18-cv-361 (E.D.N.Y. Jan. 18., 2018); and Complaint, Commodity Futures Trading Commission v. My Big Coin Pay, Inc., Carter and Gillespie et al, No. 1:18-cv-10077 (D.M. Jan. 16, 2018).
[14] See https://www.cftc.gov/PressRoom/PressReleases/pr7654-17
[15] Id.